UNITED STATES OF AMERICA
FEDERAL TRADE COMMISSION
WASHINGTON, D.C. 20580

Before the Louisiana Public Service Commission
Docket No. U-21453

Stranded Costs and Benefits

Comment of the Staff of the Bureau of Economics of the Federal Trade Commission(1) August 7, 1998

I. Introduction and Summary

The staff of the Bureau of Economics of the Federal Trade Commission (FTC) appreciates this opportunity to present its views to the Louisiana Public Service Commission (LPSC) concerning one aspect of stranded costs and benefits arising from electric industry restructuring and competition in the provision of retail electric service. Louisiana's examination of stranded costs and benefits is one phase in its multi-phased proceeding determining whether regulatory reforms in the electric industry will bring more of the benefits of competition (lower prices, improved service, and innovation) to its citizens and businesses.

The FTC is an independent administrative agency responsible for maintaining competition and safeguarding the interests of consumers. The staff of the FTC often analyzes regulatory or legislative proposals that may affect competition or the efficiency of the economy. In the course of this work, as well as in antitrust research, investigation, and litigation, the staff applies established principles and recent developments in economic theory and empirical analysis to competition issues.

The staff of the FTC has a longstanding interest in regulation and competition in energy markets, including proposals to reform regulation of the electric power and natural gas industries. The staff has submitted numerous comments concerning these issues at both the federal and state levels.(3) Moreover, the FTC has reviewed proposed mergers between electric or gas utility companies and non-utility companies.

Louisiana is among a number of states examining public interest issues surrounding recovery of stranded electric utility costs. The staff takes no position as to whether stranded cost recovery is in the public interest -- a determination best made by state and local regulators with knowledge of unique local circumstances. Whether and how to implement stranded cost recovery raises many complex policy issues that reach far beyond the scope of this comment. Instead, this comment addresses the narrow issue of how to remedy an unintended anticompetitive consequence that could flow from certain methods of stranded cost recovery in the event the LPSC decides to permit vertically-integrated, incumbent electric utilities to recover stranded costs. Certain stranded cost recovery systems may create artificial incentives for incumbent, vertically integrated electricity utilities to set prices that deter entry and harm competition. If the LPSC chooses to implement stranded cost recovery, the FTC staff recommends that it do so in a way that discourages such anticompetitive conduct by incumbent firms.

In addition, the comment briefly discusses (1) potential market distortions and inefficiencies that may accompany stranded cost recovery and ways to minimize such inefficiencies, and (2) mitigation of the level of stranded costs. These two issues were examined in the attached Open Access Comment to the Federal Energy Regulatory Commission.

II. A Possible Unintended Consequence: Stranded Cost Recovery May Create Artificial Incentives to Deter Entry(4)

One potential unintended consequence of stranded cost recovery is that incumbent firms may be able to use the stranded cost recovery system to deter potentially more efficient and innovative entry(5) and thereby delay or harm competition. If that occurred, electricity customers (municipalities, businesses, and consumers) would not only lose the benefits of price competition but also those flowing from the product and service improvements and increased product variety that competition brings. They would likely pay more than they otherwise would during the period after the stranded cost recovery period ended. The LPSC could safeguard against these unintended consequences, however, by adopting, in conjunction with any stranded cost recovery system, one of three possible remedies discussed in Section IV of this comment.

The harm to consumers would stem from the exclusion of efficient entrants during the stranded cost recovery period. The harm could result because of a connection between the way stranded costs are defined and a decision by state regulators to provide incumbent utilities with recovery of most or all of their stranded costs through surcharges on electricity use.(6) Stranded costs are often defined by calculating the difference between the (larger) net present value of future income under traditional regulation using a rate-of-return concept and the (smaller) net present value of future income under regulatory reform.(7) That is, the net present value of the income from a particular generation asset in a competitive environment is expected to be less than the income regulators would allow from a particular asset in a regulated environment.

When stranded costs are defined in this manner, the level of stranded cost recovery is inversely related to how far prices for electric power (energy charges) fall as the result of competition.(8) From the incumbent's perspective, there is an increase in revenue from stranded cost recovery for every revenue decline due to lower energy charges. With 100 percent stranded cost recovery, as some regulators have chosen, the offset is dollar-for-dollar. By contrast, the potential generation entrant has no stranded cost recovery revenue to offset lower energy charges. Thus, it could be disadvantaged by such a stranded cost recovery system because it may need to match the incumbent's lower energy charges in order to compete, but may lack the wherewithal to do so.

As competition in generation is about to begin, the vertically-integrated incumbent must decide what price (energy charge) to set for the electricity it generates. If it establishes an artificially low energy charge,(9) entry would be less likely to take place and competition from entrants may be less likely to reduce the incumbent's future profits.(10) Stranded cost recovery revenue effectively could subsidize such artificially low energy charges, without proportionately reducing the total charges to consumers.

Customers that leave a vertically-integrated incumbent and choose a new electricity supplier will typically be required to pay an energy charge, a lines charge, and a stranded cost recovery surcharge as part of their monthly electricity bill during the stranded cost recovery period.(11) Because many stranded cost recovery proposals incorporate an equalization-type formula such that stranded cost is defined as the remainder after subtracting energy and lines charges from the sum of the total charges projected under traditional rate-of-return regulation, a decrease in the energy charge prompts an offsetting increase in the stranded cost surcharge. In this circumstance, a decrease in energy charges may not be associated with any change in the total charges (price) for consumers and, thus, would be unlikely to result in increased output. Such a system also would provide less incentive for the incumbent firm to produce efficiently or to mitigate stranded costs.

Under this scenario, stranded cost recovery might become a license to block or eliminate entry, even if the entrants would be more efficient and innovative. As addressed in Section IV infra, however, there are at least three alternative remedies that may be effective to prevent this from occurring, including a structural remedy.

III. Why Vertically-Integrated Incumbents May Wish to Deter Entry

From the incumbent firm's perspective, deterring entry may be attractive if delays in entry (1) increase costs for entrants, or (2) slow establishment of a competitive market place. An incentive to deter entry may arise, for example, if the initial opening of competition by the state represents a unique window of opportunity for entrants to attract attention from potential customers at lower marketing costs than they otherwise would incur in a competitive market. In other words, the "kick-off" of retail competition is likely to be accompanied by publicity (news coverage) and government-authorized consumer education materials that are designed to raise consumer awareness of the opportunity to "shop" for power. Later entrants may face higher costs in establishing the same consumer awareness and interest in switching providers because their efforts will receive no spillover benefits from government-financed consumer information campaigns and publicity. In addition, a degree of consumer inertia may make consumers less amenable to "power shopping." If such is the case, the incumbent's ability to deter entry during this critical period of consumer interest and awareness may raise entrants' marketing costs above what they otherwise would be, over both the short and the long run.

A second incentive to deter entry may arise if there are lags in undertaking new generation and transmission investments that are needed to establish a competitive market. Delays in new investment sufficient to create a gap between the end of the stranded cost recovery period and establishment of a competitive market could stem from matters such as higher marketing costs associated with inducing customers to switch before the new supplier is ready to start supplying the market.(12) By delaying entry, the incumbent firm might slow the development of a competitive market, and thus be able to exercise generation market power between the end of the stranded cost recovery period and the birth of the competitive market. If entry can be timed perfectly, however, the transition period may be brief,(13) and such competitive problems would not arise due to this incentive.

IV. Possible Remedies to Prevent Consumer Harm if Stranded Cost Recovery is Allowed

If the stranded cost recovery mechanism allowed incumbent firms to act in the above-described manner, consumers could find total prices (including stranded cost recovery) to be no lower in the short run and higher in the long run. In addition, other benefits derived from early entry could be lost. These could include, for example, product improvements from new technology, lower-cost production methods, service innovations, and increased product variety.

The LPSC may consider the following three policy alternatives to avoid this possible harm to consumers and competition if it determines that stranded cost recovery is appropriate.(14)

1) Require that incumbent, vertically integrated firms sell (divest) their generation capacity.(15) Vertical divestiture is likely to eliminate the incentive and ability to impose higher electricity prices after stranded costs are recovered, because the incumbent firms will not be selling electricity at that time. This structural remedy may be attractive because it changes the incentives of incumbent firms and should require no additional regulatory action.

2) Establish minimum energy charges for the incumbent utility that reflect at least its fuel costs. If the incumbent utility is required to set its energy charges at least at the variable costs of fuel, alternative suppliers with lower fuel costs may find sufficient incentives to enter. (16) The regulator's tasks of collecting data, monitoring compliance, and determining variable costs (assuming variable costs can even be determined) under this type of rule, however, would require significant resources. Although this approach may discourage entry-deterring prices, it also risks discouraging competitive price reductions aimed at, for example, promoting the sampling of new products, enhancing the demand for complementary products, or learning more about demand elasticity.

3) Establish caps on electricity prices during a transition period that extends for a fixed interval beyond the stranded cost recovery period. The price cap would reduce the ability of the incumbent utility to take advantage of the lack of entry during the recovery period by raising rates immediately thereafter. One drawback of this approach is that the long-term use of pricing caps may harm competition by muting important economic signals for additional transmission or generation capacity.

V. Potential Inefficiencies and Distortions from Stranded Cost Recovery

Different methods of recovering stranded costs could have significantly different economic effects. The likely differences are explored in the public finance literature about different forms of taxation. A proposal to recover stranded costs through an additional charge on transmission services for departing customers is analogous to a sales or excise tax, with the charge paid varying in relation to the amount purchased in the future, thus possibly distorting future electricity consumption decisions. Its effects can be contrasted with the effects of a lump sum, fixed charge based on past electricity use, which would not create the same possible distortions of future electricity consumption decisions. Section V.A. of the attached Open Access Comment to FERC presents a discussion of these aspects of stranded cost recovery.

VI. Incentives to Mitigate Stranded Costs

Suppliers generally have strong incentives to respond to changing demands by undertaking product and service innovations that make the best use of their capacity. As regulation in the electric industry is reformed, suppliers of electric power could have similar incentives to innovate in order to mitigate threatened losses, such as those that are labeled here as "stranded costs." But requiring that all mitigation savings be passed through to the departing customers would effectively impose a 100 percent tax on mitigation savings, thereby discouraging additional efforts to mitigate stranded costs. Other treatments of mitigation savings may not discourage mitigation of stranded costs to the same degree. Stranded cost mitigation incentives are discussed in Section V.B. of our Open Access Comment to FERC.

VII. Conclusion

In situations where regulators allow incumbent utilities to recover stranded costs, the method of implementing such recovery is an important element of regulatory reform. If the LPSC determines to allow recovery of stranded costs, it may reduce an unintended anticompetitive consequence that harms competition and consumers by (1) taking steps to prevent vertically-integrated, incumbent electric utilities from using stranded cost recovery revenues to block or eliminate entry, (2) designing a recovery method that avoids distorting future electricity purchases, and (3) including incentives to mitigate stranded costs.

Respectfully submitted,

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1. This comment represents the views of the staff of the Bureau of Economics of the Federal Trade Commission. They are not necessarily the views of the Federal Trade Commission or any individual Commissioner.

2. This comment represents the views of the staff of the Bureau of Economics of the Federal Trade Commission. They are not necessarily the views of the Federal Trade Commission or any individual Commissioner. Inquiries regarding this comment should be directed to John C. Hilke (303-844-3565).

3. The staff of the FTC commented recently to the LPSC on market power aspects of regulatory reform and restructuring in the electric industry (LPSC, Docket No. U-21453 (May 15, 1998)). In addition, the staff of the FTC has commented on electric power regulation to the Federal Energy Regulatory Commission (FERC) in Docket No. PL98-5-000 (May 1, 1998), Docket Nos. ER97-237-000 and ER97-1079-000 (February 6, 1998), Docket No. RM96-6-000

(May 7, 1996), and Docket Nos. RM95-8-000 and RM94-7-001 (August 7, 1995)(Open Access Comment). The staff of the FTC has submitted comments to other states, including the West Virginia Public Service Commission, Case No. 98-0452-E-GI (July 15, 1998); the Utah Public Service Commission (July 15, 1998); Commonwealth of Virginia, Joint Subcommittee Studying Electric Industry Restructuring, SJR-91 (July 9, 1998); the Public Utility Commission of Texas, Project Number 17549 (June 19, 1998); the Maine Department of the Attorney General and Public Utilities Commission, "Interim Report on Market Power in Electricity" (May 29, 1998); the California Public Utilities Commission, Docket Nos. R.94-04-031 and I.94-04-032 (August 23, 1995); and the South Carolina Legislative Audit Council (February 28, 1994).

4. This discussion is developed in the context of retail competition and retail stranded costs. Similar concerns may arise concerning wholesale competition and stranded costs.

5. Entry in generation could take the form of new generation facilities, or it could consist of improved transmission capacity that makes distant generation sources more effective competitors to local generation sources.

6. Recent publications that discuss specific instances and present a similar discussion of the issues include Richard Pierce, Conceptual Issues Raised by the PECO/Enron Dispute, 11 The Elec. J. 26-38 (April 1998); and Jeffrey D. Watkiss, Retail Competition: Preliminary Results, Electric Utility Consultants' Transmission Pricing Conference, Denver, Colorado (June 26-27, 1998).

7. A 1996 state-by-state estimate lists stranded costs of $2.69 billion in Louisiana. See Ronald J. Binz, Thomas Feiler, and Michael J. McFadden, Navigating a Course to Competition: A Consumer Perspective on Electric Restructuring 38-39 (1997). In some states, the expected revenue stream under regulation may be smaller than the revenue stream under competition. This may occur, for example, if the market value of a utility's generation assets is greater than the book value of those assets. If so, the difference is termed a "stranded benefit."

8. Under traditional regulation, the price of electricity is a bundled price that includes generation and transmission/distribution components blended together. Under most competitive scenarios, the individual components are unbundled and reported separately. Here we refer to the generation component of traditional rates as the "energy charge" and the transmission/distribution components as the "lines charge."

9. The level of the incumbent's energy charge necessary to deter entry depends, in part, on the costs faced by prospective entrants. Establishing a very low energy charge -- one that is below the expected variable costs of potential entrants, for example -- is quite likely to deter entry.

10. In theory, if a state determines not to permit 100 percent stranded cost recovery, the utility's incentive to engage in entry-deterring pricing of energy charges will be weakened, depending upon the amount not recovered. Although the aggregate stranded cost recovery amount is lower, which should result in a lower total price for electricity to consumers and increased output by producers, the actual effect on output may be slight because electricity demand is commonly thought to be relatively inelastic, at least in the short run.

11. Although the new supplier would bill and collect these three charges, it would remit the stranded cost recovery surcharge to the vertically-integrated incumbent.

12. If there is uncertainty about the viability and reliability of new suppliers, as is likely, customers may be reluctant to undertake the costs of search and of switching to alternative suppliers until such suppliers are operating.

13. Similarly, if entry takes longer than the period allowed for stranded cost recovery, artificially low energy charges during the recovery period may not affect the timing of entry or the length of the transition between the end of the stranded cost recovery period and entry. Assuming that entry is motivated by prospective profit at the time the entry takes place, artificially low prices during the interim are unlikely to change the potential entrant's evaluation of the attractiveness of entry so long as entry takes longer than the stranded cost recovery period.

14. A policy of fixing the level of stranded costs at the onset may solve the problem in principle because it makes it impossible for the incumbent firm to influence the level of stranded cost recovery by lowering the energy charge during the recovery period. This may not be a sufficient remedy in practice, however, because it may motivate incumbent firms to overstate stranded costs (understate the competitive level of energy charges) and to understate its ability to reduce stranded costs in ways that deter entry and are difficult for regulators to detect.

15. Massachusetts, for example, has required that generation capacity be divested as a condition for stranded cost recovery. Edison Electric Institute, Retail Wheeling & Restructuring Report, A Quarterly Report 65 (March 1998). This approach also provides certainty about the magnitude of stranded costs by defining stranded costs as the gap, if any, between the sale price of the plants and their regulated (book) value.

16. Fuel costs (including transportation costs for fuel) typically represent a substantial proportion of total generation costs, and differences in fuel costs typically represent a large portion of the difference in the relative costs (both total and variable) of various generating facilities. Hence, a minimum energy charge set at fuel costs represents both a substantial difference from a near-zero energy charge, and a sufficient inducement to entrants to invest either in new generation with low fuel costs or new transmission providing access to low-cost generation.